1993

Insurance industry developments - 1993; Audit risk alerts

American Institute of Certified Public Accountants

AUDIT RISK ALERTS

Insurance Industry Developments—1993

Complement to AICPA Industry Audit Guide *Audits of Stock Life Insurance Companies* and AICPA Audit and Accounting Guide *Audits of Property and Liability Insurance Companies*

AICPA

American Institute of Certified Public Accountants

NOTICE TO READERS

This audit risk alert is intended to provide auditors of the financial statements of insurance companies with an overview of recent economic, industry, regulatory, and professional developments that may affect the audits they perform. This document has been prepared by the AICPA staff. It has not been approved, disapproved, or otherwise acted on by a senior technical committee of the AICPA.

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Insurance Industry Developments—1993

Industry and Economic Developments

The financial fitness of the insurance industry is currently under intense scrutiny by consumers and regulators. Rising rates for automobile and medical insurance, and concerns about the financial stability of some life insurers, have produced much consumer worry and resentment. Adding to the unrest were the efforts of several home insurers to withdraw from Florida and other hurricane-prone areas.

Property and liability insurers historically have operated in a cyclical environment. Periods of declining industry capacity and rising premium rates and volume are followed by periods in which competition for premium volume and market share drive premium rates down. The property and liability pricing environment has deteriorated steadily since 1986. However, some industry experts have predicted that the record catastrophe losses of 1992 and 1993 would be the catalyst needed to turn the pricing cycle around. Although the underwriting environment has failed to take a decidedly positive turn thus far in 1993, the deterioration in operating ratios appears to have subsided. It now appears to be steady, with only a few lines of business deviating from this pattern. While rate increases should reverse this cycle, some believe that state regulators will not approve the necessary rate increases. In the past, rate increases generally have not been adequate to cover escalating loss costs, and as a result, financial positions have deteriorated. Since some are unable to obtain approval of adequate rate increases, many insurers are reducing their exposure in unprofitable areas or are otherwise selectively writing certain businesses. This has caused concerns among regulators about possible "red-lining" practices by insurance companies.

On the commercial side, little has changed since the end of 1992. Although prices appear to be inching up, some believe that this activity will only be sufficient to offset increases in costs, and the financial results of most commercial underwriters are likely to stay flat through the end of 1993. The most active area of the property and liability sector is reinsurance, a business dominated by a limited number of players. In response to the heavy catastrophic losses over the last few years, property catastrophe coverage has become very scarce, forcing most primary insurers to retain a higher portion of the risk. This imbalance between supply and demand will likely keep reinsurance rates for property coverage moving sharply higher.

In assessing risk in auditing the financial statements of property and liability insurance companies, auditors should consider the lines of insurance that the companies write. The risk characteristics inherent in different lines of insurance vary as widely as the nature of the perils that are insured. For example, factors such as competition, the availability of reinsurance, and state commissioners' approval of premium rates may influence the risk characteristics of different lines. Therefore, auditors should evaluate the audit risks associated with different lines of business separately.

The life and health sector of the industry continues to show solid earnings growth as the economy slowly improves. A general economic rebound could affect life insurers in several ways. These include increased policy sales due to rising employment, more discretionary income invested in tax-deferred instruments through life insurance, greater access to health insurance, and slightly higher interest rates. While insurers handling health insurance have implemented price increases over the past few years, increased health care costs put a strain on company profitability and surplus positions. Many companies are abandoning the marketplace for this type of insurance, and those remaining are implementing more stringent underwriting standards.

The degree of liquidity risk inherent in the operations of insurance companies is an important element in auditors' assessments of audit risk. Liquidity risk refers to the need to have funds available to meet obligations on a timely basis. The need for appropriate matching of assets and liabilities to allow for the payment of benefits when due or demanded by policyholders is an important concern in managing life insurance companies. In assessing audit risk, auditors should consider whether adequate procedures, such as use of cash flow or asset/liability matching models, have been implemented to evaluate the liquidity and ability of insurers to pay benefits when due or demanded.

Asset quality and duration issues also remain a concern for the insurance industry. Depressed real estate conditions across the country have adversely affected investment performance and liquidity. Occupancy rates in commercial buildings remain low as companies continue to downsize, and rental rates remain low due to competitive pressures. Mortgage loan defaults are also continuing with no indication that the worst is over. Additionally, even though defaults on investments in private placements have subsided, insurers should continually monitor their portfolios for potential problems.

Overall, in the insurance industry, investment trends indicate that insurance companies have been investing new money in higher-quality, fixed-income investments. Since interest rates remain low, yields on investment portfolios are trending lower. The lower investment yields can have a very significant impact on the net income of life insurers, depending on their ability to reprice interest-sensitive liabilities. The preservation of capital continues to be a key concern for insurance companies.

Auditors should be aware that the recoverability of asset values is a significant area of audit risk and should review management's policies and procedures for determining permanent impairment and reserve requirements in the planning stages of the audit. Auditors should also carefully review management's valuation procedures for any foreclosed or in-substance foreclosed real estate. Private placements and other nonpublicly traded investments should also be carefully evaluated for impairment. Auditors of insurance entities with investments in private placements and other nonpublicly traded investments should consider using the work of a specialist in performing this portion of the audit. AICPA Statement on Auditing Standards (SAS) No. 11, *Using the Work of a Specialist* (AICPA, *Professional Standards,* vol. 1, AU sec. 336), provides guidance to auditors who use the work of a specialist in performing the audit of financial statements. (See further discussion of asset impairment in the "Audit Issues" section of this alert.)

Regulatory Developments

Regulatory Risk-Based Capital Requirements for Life Insurance Companies

Regulation of life insurance companies historically has focused on their capital. Beginning with the 1993 Annual Statement, the National Association of Insurance Commissioners (NAIC) is requiring that life insurance companies disclose risk-based capital (RBC) in their statutory filings. The RBC calculation will serve as a benchmark for the regulation of life insurance companies' solvency by state insurance departments. RBC provides dynamic surplus formulas similar to target surplus formulas used by commercial rating agencies. The formulas specify various weighting factors that are applied to financial balances or various levels of activity based on the perceived degree of risk, and are set forth in the RBC requirements. The NAIC has established certain risk-based capital ratios that trigger regulatory action levels.

Because of the importance of RBC to life insurance enterprises, RBC should be considered in assessing risk and planning the audit. The auditor should ordinarily obtain and review the client's RBC reports and should understand the RBC requirements for preparing such reports and the actual regulations associated with RBC.

The AICPA expects to issue a Statement of Position (SOP) entitled *The Auditor's Consideration of Regulatory Risk-Based Capital for Life Insurance Enterprises* (watch for an announcement in the *CPA Letter*) by the end of the year, which will provide auditors with guidance on the consideration of RBC in the planning stage of the audit as well as guidance on auditor's reports. (See also the "Disclosures of Certain Matters in the Financial Statements of Insurance Entities" discussion in the "Accounting Developments" section of this alert.)

Auditors of property and liability insurers should be alert to the fact that the NAIC is currently in the approval process of similar RBC requirements for property and liability insurance companies.

Noncompliance With Regulatory Requirements

Because insurance companies have a public responsibility to be able to meet their obligations to policyholders, state insurance statutes and regulations prescribe standards and limitations on investment activities. Regulatory requirements and restrictions vary by state. With most states restricting insurance companies from having excessive concentrations in certain classes of investments, auditors should be knowledgeable of these restrictions and perform auditing procedures to determine whether the insurance company is in compliance.

Events of noncompliance with state regulatory requirements, such as failure to meet risk-based capital or investment requirements, expose insurance companies to regulatory action. Events of noncompliance may be brought to an auditor's attention during normal auditing procedures, the review of regulatory examination reports, or as a result of actions required by regulators.

SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AICPA, *Professional Standards*, vol. 1, AU sec. 341), states that "the auditor has a responsibility to evaluate whether there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time, not to exceed one year beyond the date of the financial statements being audited." Noncompliance or expected noncompliance with regulatory requirements is a condition, when considered with other factors, that could indicate substantial doubt about the insurance company's ability to continue as a going concern for a reasonable period of time.

Audit Issues

Overall Risk Factors

Although conditions vary from company to company, the following are among the conditions that may affect audit risk in the insurance industry:

- Continued widespread competition in product pricing
- Overall increases in claims costs and benefits paid resulting from increases in litigation, the amounts of jury awards or settlements, catastrophes, the rising costs of medical care, and other large losses
- Inadequate liquidity, resulting in insufficient funds to pay claims and benefits when due or demanded by policyholders
- High levels of credit or liquidity risk associated with investments, such as real estate, mortgage loans, junk bonds, credit risks in retro-rated and experience-rated contracts and collateralized mortgage obligations
- The long-tail nature of certain property and liability lines of business, characterized by lags between the occurrence, reporting, and settlement of claims
- Extensive use of estimates, such as those for determining loss reserves or future policy benefits, in the accounting process
- Extensive and complex reinsurance arrangements and doubts about the financial viability of reinsurers
- Reliance on third parties, such as managing general agents, third-party administrators, and brokers
- Changes in levels of risk that insurers are willing to retain (that is, retention amounts)
- Extensive regulatory oversight of the industry and the changing nature of the regulatory environment
- The need to meet capital and surplus requirements imposed by regulatory authorities, and the need for sufficient capital and surplus to support company growth and stability
- The adoption of new risk-based capital requirements, which are effective in 1993 for life/health insurers

Auditors should carefully consider these industry-specific conditions and evaluate the impact these conditions have on audit risk.

Specific Conditions or Risk Factors

This section describes conditions that may vary from company to company and may indicate (but not necessarily confirm) the existence of increased audit risk.

Ineffective Management and Internal Controls. The highly competitive environment of the insurance industry is forcing many insurers to become more efficient. To increase efficiency, some insurers have reduced their staff; however, the demands of operating and reporting functions often have increased, or have remained constant. As a result, the internal control structure on the whole may become less effective. Lack of a formal management policy in administering and monitoring operations also may decrease the effectiveness of the internal control structure and affect the auditor's assessment of audit risk. Management's policies and controls over establishing adequate pricing of products, establishing loss reserves, asset/liability matching, and use of reinsurers are also important considerations in assessing and controlling audit risk for insurance companies.

SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit* (AICPA, *Professional Standards,* vol. 1, AU sec. 319), provides guidance on the independent auditor's consideration of an insurance company's internal control structure in an audit of financial statements in accordance with generally accepted auditing standards (GAAS). It describes the elements of an internal control structure and explains how an auditor should consider the internal control structure in planning and performing an audit.

Use of Accounting Estimates. Insurance companies rely heavily on the use of estimates in the preparation of financial statements. Estimates of loss reserves are generally of particular significance to the financial statements of insurers. SAS No. 57, *Auditing Accounting Estimates* (AICPA, *Professional Standards,* vol. 1, AU sec. 342), provides guidance to auditors on obtaining and evaluating sufficient, competent evidential matter to support significant accounting estimates in an audit of financial statements in accordance with GAAS. SOP 92-4, *Auditing Insurance Entities' Loss Reserves,* provides guidance to help auditors understand the loss reserving process and to develop an effective audit approach when auditing loss reserves of insurance entities.

Because the process of estimating loss reserves is complex and involves many subjective judgments, the absence of involvement by a loss reserve specialist in the determination of management's estimates may constitute a reportable condition and possibly a material weakness in the insurance company's internal control structure. SAS No. 60, *Communication of Internal Control Structure Related Matters Noted in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 325), describes the auditor's responsibility to communicate reportable conditions to the audit committee or other individuals with equivalent responsibility.

Participation in Involuntary Pools and Markets. Property and liability insurers often have significant exposure to loss development from previously reported results of various involuntary pools in which they participate, such as that experienced in 1991 and 1992 in the National Workers' Compensation Pool. Auditors should consider insurers' exposure to fund deficits of such pools in assessing audit risk and accruals. In addition, under state regulations, insurers are required to participate in mandatory pools and associations for insurance insolvencies, that is, guaranty funds. Auditors should be aware that, for certain state pools, insolvencies of major carriers may cause additional assessments to the surviving carriers. Auditors should consider management's assertions about the sufficiency of accruals and disclosures relating to participation in involuntary pools, mandatory pools and guaranty funds in accordance with Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies.*

Surplus Enhancement. Insurance companies sometimes engage in transactions to improve their statutory financial position. These transactions are commonly referred to as surplus enhancement transactions. Regulators and legislators scrutinize such transactions closely. As they assess audit risk, auditors should be alert for transactions (1) that result in a material adjustment of statutory income or surplus or (2) that affect the statutory-basis financial statements in a manner that is substantially different from the effect on statements prepared in conformity with generally accepted accounting principles. Cognizance of such transactions is especially important when an insurer's surplus is at or near statutory minimum levels. In evaluating the propriety of the accounting treatment accorded to such transactions or the related adjustments to the statutory surplus, the auditor should consider the insurer's correspondence with state insurance departments and documentation of compliance with applicable insurance laws or regulations.

An insurance enterprise's ability to continue to receive permission from the state insurance department is not guaranteed. In such circumstances, Securities and Exchange Commission (SEC) registrants should be reminded of the requirements of Item 303 of Regulation S-K, which requires disclosure of the reasonably likely effects of such uncertainties. For example, NAIC rules adopted in 1992 for life insurance companies require a phase out of reserve credits for certain reinsurance transactions. Uncertainties regarding *permitted* statutory accounting for certain transactions (for example, reinsurance) should be disclosed in the financial statements in accordance with paragraph 60 of FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises,* so that the disclosures regarding the "effects of statutory accounting practices" are not misleading to the financial statement readers.

Prescribed or Permitted Transactions Under Statutory Accounting Practices. Statutory Accounting Practices (SAP) consist of certain sources such as insurance laws, regulations, administrative rulings, and NAIC publications as well as accounting practices that are prescribed or permitted by an insurer's domiciliary insurance department and, in some instances, by the insurance departments of other states in which the insurer is authorized to do business. Insurance companies preparing SAP financial statements may adopt an accounting treatment that is not prescribed by the state of domicile or supported by other recognized sources of prescribed statutory accounting practices. In that situation, the insurer is required to have permission from the domiciliary insurance department, hence the term *permitted.* Accordingly, when an insurance company applies a statutory accounting practice that is material to its financial statements, and in the auditor's judgment is not a *prescribed* statutory accounting practice, the auditor should consider annually obtaining sufficient competent evidential matter to corroborate management's assertion that such accounting treatment is *permitted* by the domiciliary state insurance department. Written positive acknowledgment from the insurance department, and direct meetings with the regulators supported by appropriate written memoranda, are considered sufficient competent evidential matter for this purpose.

In accordance with SAS No. 58, *Reports on Audited Financial Statements* (AICPA, *Professional Standards,* vol. 1, AU sec. 508), if the auditor is unable to obtain sufficient competent evidential matter to corroborate management's assertion regarding a *permitted* statutory accounting practice which is material to the financial statements, the auditor should consider qualification or disclaimer of an opinion on the statutory financial statements due to a limitation on the scope of the audit.

The AICPA expects to issue an SOP entitled *Inquiries of Representatives of State Insurance Regulators* by the end of the year (watch for an announcement in the *CPA Letter*). This SOP will require auditors to annually obtain sufficient competent evidential matter to corroborate management's assertion that an accounting treatment is *permitted* by the domiciliary state regulators. This SOP will apply to audits of statutory financial statements for periods ending on or after December 15, 1994.

Unsound Pricing and Underwriting Practices. When determining premium rates, widespread competition in the insurance industry often leads to increased emphasis on competitors' rates. In such circumstances, premium determinations may be made without considering differences in the insured risks. Sound pricing decisions require consideration of appropriate information and reasonable estimates of expected losses and expenses. A lack of established pricing policies may lead to the acceptance of unanticipated risks or the inappropriate pricing of those risks, which could result in concerns about the recoverability of deferred acquisition costs and premium deficiencies. Auditors should evaluate the audit risk associated with unsound pricing and underwriting practices.

Asset Quality and Valuation Issues. Credit quality and other asset quality issues associated with loans, real estate portfolios, troubled debt restructurings, foreclosures and in-substance foreclosures, off-balance-sheet financial instruments, and other assets require critical attention in audits of the financial statements of insurers. Auditors should obtain reasonable assurance that management has recorded adequate asset valuation allowances and liabilities for other credit exposures based on all relevant factors. The subjectivity of determining asset valuation allowances, combined with continued economic uncertainty, reinforces the need for careful planning and execution of audit procedures in this area.

Lack of an asset impairment evaluation system or failure of an insurer to document adequately its criteria and methods for determining asset valuation allowances may indicate a material weakness in the insurer's internal control structure and will generally increase the extent of judgment that must be applied by both regulatory examiners and auditors in evaluating the adequacy of management's allowances and will increase the likelihood that differences will result. The guidance in SAS No. 57 should be followed in auditing asset valuation allowances. Other sources of information on auditing loan loss allowances include the AICPA Audit and Accounting Guides *Audits of Savings Institutions* and *Audits of Credit Unions,* the Industry Audit Guide *Audits of Banks,* and the Auditing Procedure Study *Auditing the Allowance for Credit Losses of Banks.* The Audit and Accounting Guide *Guide for the Use of Real Estate Appraisal Information* provides guidance to help auditors understand real estate appraisal concepts and information.

As with credit risk, other valuation issues involve many subjective assumptions. For example, the expected effects of prepayments on loans in portfolios and the types of income and expense items included in valuations of loan servicing assets have a significant impact on the recorded values of those assets. High levels of prepayments of mortgage loans, for example, have resulted in impairment of many assets, such as purchased mortgage servicing receivables and interest-only securities. Evaluation and recognition of impairment due to prepayments should include consideration of the insurer's aggregation policy, discount rates, and assumptions about the future prepayment rates.

Further, falling interest rates have created an environment in which transactions involving gains trading of securities, refinancing of loans, restructuring of nonperforming assets, origination of loans to facilitate the sale of real estate owned, and other asset dispositions all require specific attention. Such transactions require an understanding of the specific situations so that the auditor may carefully assess and control audit risk.

Derivatives and Other High-Risk Investments. In recent years there has been a growing use of innovative financial instruments that often are very complex and can involve a substantial risk of loss. Users and issuers of such instruments must have the expertise necessary to understand and manage the related risks. As discussed below, auditors should also be familiar with such instruments and the associated risks. One class of these instruments—derivatives—requires particular attention.

Derivatives are complex financial instruments whose values depend on the values of one or more underlying assets or financial indexes. Derivatives generally fall into at least two categories:

- Asset-backed securities, which include mortgage-backed securities, interest-only and principal-only strips, and tranches of collateralized mortgage obligations
- Off-balance-sheet instruments such as forward contracts, interest-rate and currency swaps, futures, options and other financial contracts

By reconfiguring cash flows associated with underlying assets, an issuer can create asset-backed securities that meet the needs of and are attractive to various potential users by isolating, enhancing, or diluting one or more of credit, liquidity, interest-rate, and other risks inherent in the underlying cash flows. For example, through mortgage-backed securities, the issuer can enhance the marketability of underlying mortgage loans by spreading liquidity and credit risk across broad pools, or by providing a higher yield to those users willing to accept a higher concentration of the risks associated with specific collateral cash flows. Similarly, users find certain derivatives attractive because they can purchase the risks and rewards they desire most, or can synthetically create a security with the desired risk and reward characteristics.

Increased volatility of interest rates, foreign exchange rates, and commodity and other prices has also fostered tremendous innovation in financial products to meet the needs of users attempting to hedge or alter the related risks. Swaps, for example, are financial contracts in which two parties exchange streams of payments over a period of time. An entity with debt that carries variable interest rates (such as an entity that has short-term certificates of deposit) might swap interest rate payments on an agreed-upon principal amount with a counterparty by paying a fixed rate and receiving a variable rate. The entity locks into an interest rate for the term of the swap, reducing the risk that increases in interest rates will increase the entity's cost of funds as its liabilities are refunded or related interest rates are reset. The entity takes on other risks, however, such as the risk that the counterparty could default on its payments. By locking into fixed rates, the entity will no longer benefit from interest rate decreases during the term of the swap and it is often costly to terminate a swap. Further, the fair value of derivatives can be volatile in periods of changing market conditions.

Accounting. Accounting for derivatives is complex. Given the constant innovation and complexity of derivatives, accounting literature does not explicitly cover some derivatives; however, several related projects are underway.

The FASB has been carrying out a major project on the recognition and measurement of financial instruments, which has already resulted in the issuance of FASB Statements No. 105, *Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk*, No. 107, *Disclosures about the Fair Values of Financial Instruments*, and No. 115, *Accounting for Investments in Certain Debt and Equity Securities*, and FASB Interpretation No. 39, *Offsetting of Amounts Related to Certain Contracts*, that address related issues. The FASB's project includes a comprehensive review of accounting for hedging and risk-adjusting derivatives. Also, the International Accounting Standards Committee is in the process of developing an international accounting standard for financial instruments.

Several accounting issues involving derivatives have also been addressed by the FASB's Emerging Issues Task Force (EITF). Other guidance is provided by FASB Statements No. 52, *Foreign Currency Translation*, and No. 80, *Accounting for Futures Contracts*. In addition, AICPA Issues Paper No. 86-2, *Accounting for Options*, discusses various matters related to options.

Auditing. The innovative and complex nature of such investment vehicles may significantly increase audit risk. For example, as more and more financial institutions enter the markets for such instruments, their profitability may diminish. Traders may attempt to compensate for the diminution by increasing the volume of transactions involving such instruments or by further customizing products. An increase in volume may be accompanied by trading with counterparties that have higher credit risk. Customizing transactions may increase valuation difficulties. The propriety of the methods used by the managements of insurance companies to account for transactions involving sophisticated financial instruments and to determine their value should be carefully considered. Understanding the substance of transactions in such instruments is important in determining the propriety of their accounting treatment. In some circumstances, auditors may find it helpful to consult with experts.

SAS No. 22, *Planning and Supervision* (AICPA, *Professional Standards,* vol. 1, AU sec. 311), requires that auditors understand the events, transactions, and practices that, in their judgment, may have a significant effect on the financial statements. Accordingly, auditors should carefully consider the various risks involved with investments in derivatives and other complex securities as they plan their audits and should—

1. Assess management's expertise in monitoring, evaluating, and accounting for the securities.
2. Ensure that the entity has set appropriate policies and procedures for investment in high-risk securities and that there is adequate oversight by the board of directors.
3. Involve specialists, when necessary, in valuing and auditing these investments.

Significant Real Estate Holdings. Some insurance companies (particularly life insurers) may have significant owned or leased real estate or may provide financing under real estate collateralized obligations. Because of the weak real estate market, certain current values are significantly lower than those even as recent as six months to a year ago. One of the contributing factors to the rapid decline in values is the emergence of substantial real estate portfolios available for sale. Insurance companies that have provided real estate financing may not have considered the full impact of these value declines. Even recent independent appraisals may have failed to fully reflect current market conditions as the appraisal may be based in part on specific assumptions stipulated by the company ordering the appraisal. Real estate, although traditionally considered a long-term investment, is currently even less liquid than in prior years, because of excess supply and limited credit availability.

The following are some conditions which may indicate a need for auditors to further consider the appropriateness of real estate valuations and related disclosures:

- Cash flows from operating activities are insufficient to cover debt service.
- Current occupancy rates indicate that the future cash flows to be received from the investment are lower than the amounts needed to fully recover the investment's carrying amount.
- The lessor is having to make significant concessions in order to rent the property.
- Properties held for sale remain unsold at subsequent balance sheet dates.
- The number of delinquent loans or repossessed properties has increased.
- The value of the real estate that collateralized nonrecourse mortgage loans has declined.
- Other investors have decided to cease providing support or to reduce their financial commitment to the real estate project or venture.
- The previous year's auditor's report contains an explanatory or emphasis paragraph relating to real estate investments.

When circumstances such as these are present, auditors should consider the need for appropriate write-downs or reserves and the impact on any disclosures required by or presented voluntarily in accordance with FASB Statement No. 107. Interpretation No. 1, "Performance and Reporting Guidance Related to Fair Value Disclosures," of SAS No. 57 (AICPA, *Professional Standards*, vol. 1, AU sec. 9342) was issued in February 1993 to provide auditors performance and reporting guidance related to fair-value disclosures.

Auditors should also consider whether real estate held for investment is reported at cost less accumulated depreciation. If it appears that an investment in real estate may be sold, or the insurance company cannot demonstrate the ability to hold the real estate indefinitely, or the property is classified as in-substance foreclosed in accordance with AICPA Practice Bulletin No. 7, *Criteria for Determining Whether Collateral for a Loan Has Been In-Substance Foreclosed*, then the auditor should consider whether the accounting principles applicable to real estate held for sale are being followed. Real estate held for sale, other than foreclosed real estate held for sale (which should be accounted for in accordance with SOP 92-3, *Accounting for Foreclosed Assets*), should be carried at the lower of cost or estimated net realizable value using a valuation account to reflect declines in net realizable value from the carrying value on an individual property basis, in accordance with FASB Statement No. 67, *Accounting for Costs and Initial Rental Operations of Real Estate Projects*.

Reinsurance Arrangements. Reinsurance arrangements can be complex and reinsurance contracts can be complicated. Adequate control over a company's reinsurance program requires that management have knowledge and understanding of the reinsurance business and the financial effects of reinsurance. The lack of an adequate reinsurance program may expose an insurance company to risks that can jeopardize its financial stability, particularly if its risks are concentrated by type or geographic area. In contrast, excessive reinsurance coverage can significantly reduce the margins available to cover fixed and overhead expenses. Auditors should obtain an understanding of the reinsurance programs of the insurance entities that they audit. Significant changes in an insurer's reinsurance programs or retention limits may be relevant to the auditor's assessment of audit risk related to estimates of loss reserves or reinsurance recoverable. Auditors should also consider whether management has established policies for selecting reinsurers and monitoring reinsurers' ability to pay reinsurance claims when they come due.

Because of recent catastrophic events, insurers are using reinstatement reinsurance to reduce exposures. Auditors should evaluate whether layers of reinsurance programs have been pierced and whether additional premiums for reinstatement reinsurance have been properly reported.

The collectibility of amounts due under ceded reinsurance arrangements continues to be of concern to the insurance industry. Collectibility problems may arise if the assuming company becomes financially unsound or if there is a dispute concerning coverage. The AICPA Audit and Accounting Guide *Audits of Property and Liability Insurance Companies* discusses the controls or procedures that ceding companies should implement to evaluate the financial stability of assuming companies. Collectibility concerns can also arise when assuming companies challenge or repudiate reinsurance claims based on disagreements over interpretations of contract terms or allegations that a ceding company has not fulfilled its contractual obligations.

Assumed reinsurance may be difficult to underwrite because the coverage is often unique. Accordingly, some companies, particularly those that only occasionally assume reinsurance, may not have sufficient experience to manage such business or may not have adequate procedures to evaluate underwriting standards, or to monitor the business. In addition, assuming companies may experience significant delays in receiving information from ceding companies, intermediaries, retrocessionaires, or other parties to the contracts, which may result in delays in notification of amounts of written premiums or losses incurred under contracts, or a lack of supporting information needed for financial reporting and administration of the business.

Further guidance on auditing reinsurance arrangements is provided in the AICPA Audit and Accounting Guide *Audits of Property and Liability Insurance Companies* and in the SOPs *Auditing Property and Liability Reinsurance* (originally issued in 1982) and *Auditing Life Reinsurance* (originally issued in 1984). Accounting issues and developments concerning reinsurance arrangements are discussed in detail in the "Accounting Developments" section of this alert.

Related-Party Transactions. Certain related-party transactions are currently receiving a great deal of public and regulatory scrutiny. These transactions include—

- Loans to insurance companies' officers and directors or their affiliates.
- Fees or commissions paid to officers and directors or their affiliates.
- Other arrangements, including purchased goods or services from and contracts with officers and directors or their affiliates.

SAS No. 45, *Omnibus Statement on Auditing Standards—1983* (AICPA, *Professional Standards*, vol. 1, AU sec. 334), provides guidance on procedures that should be considered by auditors in order to identify related-party relationships and transactions and to satisfy themselves concerning the accounting for and disclosure of transactions with related parties.

Audit Developments

Auditing Property/Casualty Insurance Entities' Statutory Financial Statements—Applying Certain Requirements of the NAIC Annual Statement Instructions

SOP 92-8, *Auditing Property/Casualty Insurance Entities' Statutory Financial Statements—Applying Certain Requirements of the NAIC Annual Statement Instructions*, was issued in October 1992 and provides guidance on the impact of certain requirements of the NAIC's Annual Statement Instructions—Property and Casualty on the auditor's procedures in the audit of statutory financial statements of property and liability insurance entities. SOP 92-8 is effective for audits of statutory-basis financial statements of property and liability insurance entities for periods ending after December 15, 1992.

Accounting Developments

Assumption Reinsurance

Unlike typical reinsurance, assumption reinsurance is intended to extinguish the primary insurer's obligations to the policyholder, and is reported in a manner similar to the disposition of a business rather than as reinsurance. Under assumption arrangements, the primary insurer typically transfers the policies without the prior consent of the policyholders. Auditors should evaluate the insurance company's determination whether a given contract is assumption or novation reinsurance. The determination of whether an involuntary transfer without the prior consent of the policyholder that is the result of an assumption reinsurance contract extinguishes the ceding company's liability to its policyholders is a legal determination. Auditors should confer with legal counsel in their evaluation of the appropriateness of the insurance company's determination. Associated contingencies may require footnote disclosure pursuant to FASB Statement No. 5. If a contract is appropriately determined to be an assumption reinsurance contract, the auditor should consider whether the ceding company has removed the related assets and liabilities from its financial statements since the ceding company no longer has any liability to the policyholder.

Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts

In December 1992, the FASB issued FASB Statement No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts,* which specifies the accounting by insurance companies for the reinsuring (ceding) of insurance contracts. It amends FASB Statement No. 60 to eliminate the practice by insurance companies of reporting assets and liabilities relating to reinsured contracts net of the effects of reinsurance. The Statement requires reinsurance receivables (including amounts related to claims incurred but not reported and liabilities for future policy benefits) and prepaid reinsurance premiums to be reported as assets. Estimated reinsurance receivables are recognized in a manner consistent with the liabilities relating to the underlying reinsured contracts.

The Statement establishes the conditions required for a contract with a reinsurer to be accounted for as reinsurance and prescribes accounting and reporting standards for those contracts. The accounting standards depend on whether the contract is long-duration or short-duration and, if short-duration, on whether the contract is prospective or retroactive. For all reinsurance transactions, immediate recognition of gains is precluded unless the ceding company's liability to its policyholder is extinguished. Contracts in which the reinsurer does not assume significant insurance risk or that do not result in the reasonable possibility that the reinsurer may realize a significant loss from the insurance risk assumed generally do not meet the conditions for reinsurance accounting and are to be accounted for as deposits. Determining whether a contract with a reinsurer provides indemnification against loss or liability relating to insurance risk requires a complete understanding of that contract and other contracts or agreements between the ceding enterprise and related reinsurers. A complete understanding includes an evaluation of all contractual features that (1) limit the amount of insurance risk to which the reinsurer is subject or (2) delay the timely reimbursement of claims by the reinsurer.

Auditors should consider whether ceding companies adequately disclose the nature, purpose, and effect of reinsurance transactions, including the premium amounts associated with reinsurance assumed and ceded. Auditors should also consider whether disclosure of concentrations of credit risk associated with reinsurance receivables and prepaid reinsurance premiums is adequate as required by the provisions of FASB Statement No. 105.

Auditors should refer to FASB Viewpoints, "Accounting for Reinsurance," in the February 26, 1993, *FASB Status Report* for additional guidance. Auditors of SEC registrants should be aware that the SEC staff will expect property and liability insurance companies to disclose loss reserve tables on a gross basis, in the year the insurance company adopts FASB Statement No. 113. For periods prior to 1993, the SEC has indicated that restatement to reflect gross amounts is encouraged, but not required. If a registrant elects to restate its financial statements, the restatement of data for all prior periods included in the Guide 6 tables (and the Selected Financial Data presented pursuant to Item 301 of Regulation S-K) will result in the most consistent and useful presentation. However, the SEC will accept an alternative presentation where the registrant's prior reserving practices make restatement for all periods impracticable provided that the reasons for not restating the data in the Guide 6 tables are disclosed.

FASB Statement No. 113 is effective for financial statements for fiscal years beginning after December 15, 1992. Auditors of insurance companies with long-duration and short-duration reinsurance contracts should give the following aspects of the Statement particular consideration:

1. Whether reinsurance contracts are appropriately identified as short-duration or long-duration
2. Whether contracts determined to be short-duration are appropriately identified as either prospective or retroactive reinsurance

3. Whether contracts indemnify the ceding company against loss or liability and therefore meet the conditions for reinsurance accounting
4. If reinsurance contracts are determined to be "assumption reinsurance" contracts as described above, whether all related assets and liabilities are removed from the ceding company's financial statements
5. Whether amounts receivable and payable between the ceding company and an individual insurer should be offset under the requirements of FASB Interpretation No. 39

Accounting for Funding Cover Arrangements

The FASB's EITF reached a consensus on Issue No. 93-6, *Accounting for Funding Cover Arrangements*. An insurer (ceding enterprise) may enter into a multiple-year retrospectively rated reinsurance contract (RRC) with a reinsurer (assuming enterprise). Examples of these contracts may include transactions referred to as "funded catastrophe covers."

These contracts include a "retrospective rating" provision that provides for at least one of the following based on contract experience: (1) changes in the amount or timing of future contractual cash flows, including premium adjustments, settlement adjustments, or refunds to the ceding enterprise, or (2) changes in the contract's future coverage. A critical distinguishing feature of these contracts is that part or all of the retrospective rating provision is obligatory such that the retrospective rating provision creates future rights and obligations as a result of past events. A retrospectively rated contract that could be canceled by either party without further obligation is not covered by this Issue.

The Task Force reached a concensus that (1) to the extent that the ceding enterprise has an obligation to make payments to the reinsurer that would not have been required absent experience to date under the contract (for example, payments that would not have been required if losses had not been experienced), whether the ceding enterprise should recognize a liability and the assuming enterprise should recognize an asset, (2) to the extent that a ceding enterprise would be entitled to receive a payment from the reinsurer based on experience to date under the contract (for example, the ceding enterprise would receive a payment if no future losses occur), the ceding enterprise should recognize an asset and the assuming enterprise should recognize a liability, and (3) the ceding enterprise and the assuming enterprise should account for changes in coverage in the same manner as changes in the other contract costs—that is, based on past experience under the contract.

The Task Force also reached a consensus that in order to be accounted for as reinsurance, a contract that reinsures risks arising from short-duration insurance contracts must meet all of the following conditions: (1) the contract must qualify as a short-duration contract under paragraph 7(a) of FASB Statement No. 60, (2) the contract must not contain features that prevent the risk transfer criteria in paragraphs 8 through 13 of FASB Statement No. 113 from being reasonably applied (and those criteria must be met), and (3) the ultimate premium expected to be paid or received under the contract must be reasonably estimable and allocable in proportion to the reinsurance protection provided as required by paragraph 14(a) and (b) of FASB Statement No. 60 and paragraph 21 of FASB Statement No. 113. If any of these conditions are not met, a deposit method of accounting should be applied by the ceding and assuming enterprises.

FASB Financial Instruments Project

The FASB's agenda continues to include a project on financial instruments that encompasses three primary segments: disclosures, distinction between liabilities and equity, and recognition and measurement. In addition to these three primary segments, the FASB has addressed several narrower issues within the overall scope of the project. Some of the current developments of the project are described in the following sections.

Impairment of a Loan. In May 1993, the FASB issued FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan,* which addresses the accounting by creditors for impairment of certain loans. The Statement is applicable to all creditors and to all loans, uncollateralized as well as collateralized, except large groups of smaller-balance homogeneous loans that are collectively valued for impairment, loans that are measured at fair value or at the lower of cost or fair value, leases, and debt securities as defined in FASB Statement No. 115. It applies to all loans that are restructured in a troubled debt restructuring involving a modification of terms.

FASB Statement No. 114 requires that impaired loans that are within its scope be measured based on the present value of expected future cash flows discounted at the loan's effective interest rate or as a practical expedient, at the loan's observable market price or the fair value of collateral if the loan is collateral-dependent.

The Statement amends FASB Statement No. 5 to clarify that a creditor should evaluate the collectibility of both contractual interest and contractual principal of all receivables when assessing the need for a loss accrual. The Statement also amends FASB Statement No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructuring,* to require a creditor to measure all loans that are restructured in a troubled debt restructuring involving a modification of terms in accordance with its provisions.

The Statement applies to financial statements for fiscal years beginning after December 15, 1994. Earlier application is encouraged.

Sources of guidance relevant to auditing loan loss allowances are described on page 13.

Some insurers may adopt the provisions of the Statement prior to its effective date. Auditors of the financial statements of such insurers should carefully consider the implications of applying the new provisions of the Statement on audit risk. Aspects of applying the new Statement that warrant particular consideration include—

- Proper identification of all loans to which the Statement should be applied.
- The reasonableness of estimates of future cash flows and interest rates used in discounting.
- The appropriateness of amounts used to measure impairment if alternatives to present value amounts, such as fair values of collateral or observable market prices, are used.
- The relationship between the identification of impaired loans under the Statement and the classification of loans under regulatory classification systems.
- The presentation of accrued interest receivable and its relationship to valuation allowances.
- The relevance of concepts of performing and nonperforming assets.

Investments in Debt and Equity Securities. In May 1993, the FASB issued FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities,* which addresses the accounting and reporting for investments in equity securities that have readily determinable fair values (previously addressed by FASB Statement No. 12, *Accounting for Certain Marketable Equity Securities*) and for all investments in debt securities. FASB Statement No. 115 does not cover securities accounted for by the equity method and investments in consolidated subsidiaries. FASB Statement No. 115 establishes three categories of reporting debt and marketable equity securities:

- Held-to-maturity securities (debt securities that the insurer has the positive intent and ability to hold to maturity), to be reported at amortized cost
- Trading securities (debt and equity securities that are bought and held principally for the purpose of selling them in the near future),

to be reported at fair value, with unrealized gains and losses included in earnings

- Available-for-sale securities (debt and equity securities not classified as either held-to-maturity or trading), to be reported at fair value, with unrealized gains and losses excluded from earnings and reported in a separate component of equity until realized

Mortgage-backed securities that are held for sale in conjunction with mortgage-banking activities (as described in FASB Statement No. 65, *Accounting for Certain Mortgage Banking Activities*), are classified as trading securities. Mortgage-backed securities that are currently not held-for-sale in conjunction with mortgage-banking activities may be classified in one of the two other categories, as appropriate.

FASB Statement No. 115 also requires insurers to determine whether declines in the fair value of individual securities classified as either held-to-maturity or available-for-sale below their amortized cost bases are other than temporary. For example, if it is probable that an investor will be unable to collect all amounts due according to the contractual terms of a debt security not impaired at acquisition, an other-than-temporary impairment is considered to have occurred. If such a decline is judged to be other than temporary, the cost basis of the individual security should be written down to fair value as the new cost basis, with the amount of the write-down included in earnings (that is, accounted for as a realized loss).

The Statement also specifies the accounting treatment for transfers between categories.

The Statement (paragraph 8) indicates that certain changes in circumstances may cause the enterprise to change its intent to hold a certain security to maturity without calling into question its intent to hold other debt securities to maturity in the future. Such circumstances include evidence of a significant deterioration in the issuer's creditworthiness or a change in tax law that eliminates or reduces the tax-exempt status of interest on the debt security. In addition, other events that are isolated, nonrecurring, and unusual for the reporting enterprise that could not have been reasonably anticipated may cause an enterprise to sell or transfer a held-to-maturity security without necessarily calling into question its intent to hold other debt securities to maturity. Such sales and transfers of held-to-maturity securities are expected to be rare.

An entity shall not classify a debt security as held-to-maturity if it has the intent to hold the security for only an indefinite period. Consequently, a debt security should not, for example, be classified as held-to-maturity if the enterprise anticipates that the security would be available to be sold in response to changes in market interest rates and related changes in the security's prepayment risk, needs for liquidity, changes in the availability of and the yield on alternative investments, changes in funding sources and terms, and changes in foreign-currency risk.

FASB Statement No. 115 is effective for fiscal years beginning after December 15, 1993. It specifically prohibits retroactive restatement of prior financial statements. Although typically FASB Statement No. 115 would be initially applied as of the beginning of a fiscal year (such as January 1, 1994), entities are permitted to initially apply the Statement as of the end of an earlier annual period for which financial statements have not been issued (with no restatement of interim periods).

Since all insurers with a calendar fiscal year must classify their investments in securities in accordance with FASB Statement No. 115 as of January 1, 1994, those insurers will also be able to apply the Statement as of December 31, 1993, if they wish to do so in their 1993 annual financial statements. Thus, auditors should be aware of some of the issues that are likely to arise when the Statement is applied. Auditing financial statements involving the classification of investments in debt and equity securities pursuant to FASB Statement No. 115 may involve a high degree of judgment about such matters as the following:

- How auditors should evaluate subjective exceptions for sales of securities designated as held-to-maturity (including the interpretation of restrictive terms such as *isolated, nonrecurring,* and *unusual*)
- How auditors should evaluate the ability of an insurer to hold securities to maturity, particularly when going-concern issues arise
- Whether cash flow projections are needed in conjunction with assessing an insurer's ability to hold securities to maturity
- How to evaluate whether impairments of investments are other than temporary

Applicability of Generally Accepted Accounting Principles to Mutual Life Insurance Companies

In April 1993, the FASB issued Interpretation No. 40, *Applicability of Generally Accepted Accounting Principles to Mutual Life Insurance and Other Enterprises,* an interpretation of FASB Statements No. 12, *Accounting for Certain Marketable Securities,* No. 60, and No. 97, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Contracts.* The Interpretation clarifies that companies, including mutual life companies, that issue financial statements described as prepared "in conformity with generally accepted accounting principles" are required to apply all applicable authoritative accounting pronouncements in preparing those statements. The Interpretation concludes that mutual life insurance companies, who, like a number of other regulated companies, prepare financial statements based on regulatory accounting practices that differ from generally accepted accounting principles and distribute those financials to regulators, should not describe these financial statements as prepared "in conformity with generally accepted accounting principles."

The Interpretation is effective for financial statements issued for fiscal years beginning after December 15, 1994, except for the disclosure provisions, which are effective for fiscal years beginning after December 15, 1992. Earlier application is encouraged. The disclosures required to be made by mutual insurance companies for fiscal years beginning after December 15, 1992 include—

- The accounting principles and methods used to account for investments in debt and equity securities and insurance activities in accordance with Accounting Principles Board (APB) Opinion No. 22, *Disclosure of Accounting Policies.*
- A brief description of Interpretation No. 40, including its effective date and transition provisions, and that financial statements prepared on the basis of statutory accounting principles will no longer be described as prepared in conformity with generally accepted accounting principles after the effective date of this Interpretation.

Disclosures of Certain Matters in the Financial Statements of Insurance Entities

The AICPA plans to expose for public comment a proposed SOP, *Disclosures of Certain Matters in the Financial Statements of Insurance Entities,* in the first quarter of 1994. The proposed SOP would require (1) all property and liability insurance companies to make additional disclosures about their liability for unpaid claims, (2) all insurance companies to make additional disclosures about the differences between accounting methods permitted for certain transactions, and (3) certain risk-based capital disclosures for life insurance companies.

Disclosures—Publicly Held Companies

Management's Discussion and Analysis. SAS No. 8, *Other Information in Documents Containing Audited Financial Statements* (AICPA, *Professional Standards,* vol. 1, AU sec. 550), requires that auditors read such information and consider whether it and the manner of its presentation are materially consistent with information appearing in the financial statements. As auditors of insurance companies that are required to file reports with the SEC read the Management's Discussion and Analysis of Operations (MD&A) sections of SEC filings, they might consider whether the MD&A includes discussions of—

- The effects of reinsurance on results of operations and liquidity. Effects of catastrophes should be discussed both gross and net of reinsurance, in the aggregate and for material individual catastrophes. Recent large catastrophes have caused substantial changes in the relationships between reinsurance premiums and related loss recoveries from historical levels.
- The quantitative characteristics of their policy liabilities, including expected duration, interest crediting rates, and surrenderability, and the relationship of these characteristics to the characteristics of the investment portfolio that supports the liabilities. The liabilities of life insurance companies are fundamentally different from those of property and liability insurance companies; therefore, multi-line insurance companies generally should discuss each separately.
- The impact of recently issued accounting standards which are not effective until some future date. If the adoption of a standard is expected to have a significant effect on the insurance company's financial position or results of operations, the MD&A disclosure should (1) notify that a standard has been issued which the insurance company will be required to adopt in the future, and (2) assess the significance of the impact that the adoption of the standard should have on the company's financial statements (unless this cannot be reasonably estimated, in which case, a statement to that effect should be made).
- The potential consequences of failure to meet the NAIC RBC requirements, as well as disclosure of the actual and required RBC amounts.

Environmental Issues. The Environmental Protection Agency is empowered by law to seek recovery from any party that ever owned or operated a contaminated site and from anyone who ever generated or transported hazardous materials to a site. In view of the liabilities that may result from owning contaminated sites, virtually all real estate transactions entered into today give consideration to potential environmental liabilities. Auditors of insurance entities that face such claims in connection with property they insure or in connection with their own real estate holdings and transactions or other should carefully evaluate whether the accounting and disclosure requirements of FASB Statement No. 5 have been met. They should also be cognizant of the consensus reached by the FASB's EITF in Issue 93-5, *Accounting for Environmental Liabilities,* that, among other things, an environmental liability should be evaluated independently from any potential recovery and that the loss arising from the recognition of an environmental liability should be reduced only when a claim for recovery is probable of realization.

Auditors of publicly held insurance entities should also consider the adequacy of note disclosures of the nature and magnitude of environmental claims, including the range of possible loss, or a statement that it is not estimable. Such disclosures should be made in accordance with the requirements of SEC Staff Accounting Bulletins (SABs) No. 87, *Views on Contingency Disclosures on Property-Casualty Insurance Reserves for Unpaid Claim Costs*, and No. 92, *Accounting and Disclosures Relating to Loss Contingencies.* SAB No. 92 also provides the SEC staff's interpretation of current accounting literature related to the following:

- Offsetting of probable recoveries against probable contingent liabilities
- Recognition of liabilities for costs apportioned to other potential responsible parties
- Uncertainties in estimation of the extent of environmental or product liability
- The appropriate discount rate for environmental or product liabilities, if discounting is appropriate
- Accounting for exit costs
- Financial statement disclosures and disclosure of certain information outside the basic financial statements

Auditors should also consider the adequacy of accounting policy disclosures for reserves, which should state clearly whether a provision for incurred-but-not-reported claims is included. Auditors should also consider whether disclosures include reserve balances and activity relating to environmental and product liability claims for periods covered by financial statements, along with a discussion of related trends and uncertainties. These disclosures should be made under the guidelines of SEC Industry Guide 6 and Item 303 of Regulation S-K. *Audit Risk Alert—1993* includes a detailed discussion of additional accounting and auditing issues relating to environmental costs.

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This Audit Risk Alert replaces *Insurance Industry Developments—1992.*

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Auditors should also be aware of the economic, regulatory, and professional developments that may affect the audits they perform, as described in *Audit Risk Alert—1993,* which may be obtained by calling the AICPA Order Department at the number below and asking for product number 022099.

Copies of AICPA publications referred to in this document may be obtained by calling the AICPA Order Department at (800) TO-AICPA. Copies of FASB publications referred to in this document can be obtained directly from the FASB by calling the FASB Order Department at (203) 847-0700, ext. 10.

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